
Corporate Governance Update

As of July 24, 2014

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2014 PROXY SEASON REVIEW AND RECENT DEVELOPMENTS

Top Ten 2014 Proxy Season Trends

- Results in director elections and shareholder proposals reflect slight shifts
- Annual meetings continue to draw criticism and protests
- Activists and proxy contests dominate the news
- Continued experimentation with company bylaws to address shareholder litigation and other concerns
- Regulatory rulemaking pace moves slowly even as requests for regulatory intervention grow
- Board composition, especially tenure, comes into sharper focus
- Board oversight responsibilities questioned
- Shareholder engagement increasingly expected
- Executive compensation remains in the spotlight
- Proxy advisory firm influence continues

1. Directors Elections and Shareholder Proposals

DIRECTOR ELECTION RESULTS AS OF JUNE

- Support for directors continued with vast majority receiving over 90%
- Influence of proxy advisory services evident but diffused
 - 3,000 directors at more than 1,000 companies faced negative ISS recommendations
 - Negative recommendations target mostly mid-cap and small-cap companies, since smaller companies have not adopted governance reforms and generally have plurality voting, so they can ignore low vote results year after year
 - Only about 1% (less than 40) received more negative votes than votes in favor
 - Only 3 directors at S&P 500 companies
 - Most common reasons for negative ISS recommendations
 - Non-audit fees as proportion of audit fees and ISS determines a director who sits on a key committee is not “independent” even after the board finds that director to be independent
 - Most common reasons for directors receiving less than majority votes in favor of election
 - Failure to act on a shareholder proposal that received majority support
 - Independence issues (ISS perceives the director to be non-independent under its own standards)
 - Other governance factors such as adopting a poison pill without shareholder support; poor attendance; overboarding

1. Director Elections and Shareholder Proposals

OVERVIEW OF 2014 DATA (AS OF JUNE)

- Overview of shareholder proposals (Rule 14a-8 proposals for inclusion in proxy statements)
 - 830 proposals submitted as of mid-2014 (compared with 840 in all of 2013)
 - 53% – environmental and social issues, 6% increase from 2013
 - 28% of those focused on political activities (120 proposals) which includes political contributions and lobbying
 - 38% – governance topics
 - 9% – compensation matters
- But a vast number do not end up on ballots
 - 435 shareholder proposals voted on as of June, reflecting the SEC exclusion process but also the greater predictability of outcomes, which often leads to settlements or withdrawals
 - Compared to 576 shareholder proposals in all of 2013 and 676 in 2012
 - Slightly more than 15% “pass” (receive more “for” votes than “against” votes, not counting abstentions)
- Who receives proposals and who submits them
 - S&P 500 companies have more than 80% of the proposals on their ballots
 - But a decrease from prior years, as they have adopted most of the more common governance practices sought by proposals
 - In 2013, retail shareholders were most prolific proponents (40%), followed by labor unions and then pension funds (34%) and social policy or religious institutions (25%)
 - Two individuals accounted for 24% of the retail proposals
 - Some uptick in activists using 14a-8 (Apple, eBay, Red Lobster, Allergan)

1. Director Elections and Shareholder Proposals

SHAREHOLDER PROPOSAL LAWSUITS

- Lawsuits against shareholder proponents to exclude proposals
 - Four companies decided to go outside the SEC process because SEC precedents indicated these proposals were unlikely to be excluded by the SEC staff
 - Express Scripts (TX) allowed to exclude proposal based on false and misleading supporting statements
 - Courts in Omnicom (NY), EMC (MA) and Chipotle denied the companies' declaratory judgment motions
 - Courts decided that based on Chevedden's promise not to sue the companies if they reject his proposal, and given the possibility of SEC investigation is remote, then the threat of injury was not actual or imminent
 - Shareholder group of 20 socially responsible investors criticized companies in a letter to the SEC for suing investors to stop the proposals – questioned expense of litigation when SEC process is available
 - In one case, a preliminary injunction was sought (and denied) against Wal-Mart to force the company to include a proposal the SEC had allowed to be excluded

1. Director Elections and Shareholder Proposals

NOTABLE NO-ACTION LETTERS AND QUESTIONS ABOUT THE PROCESS

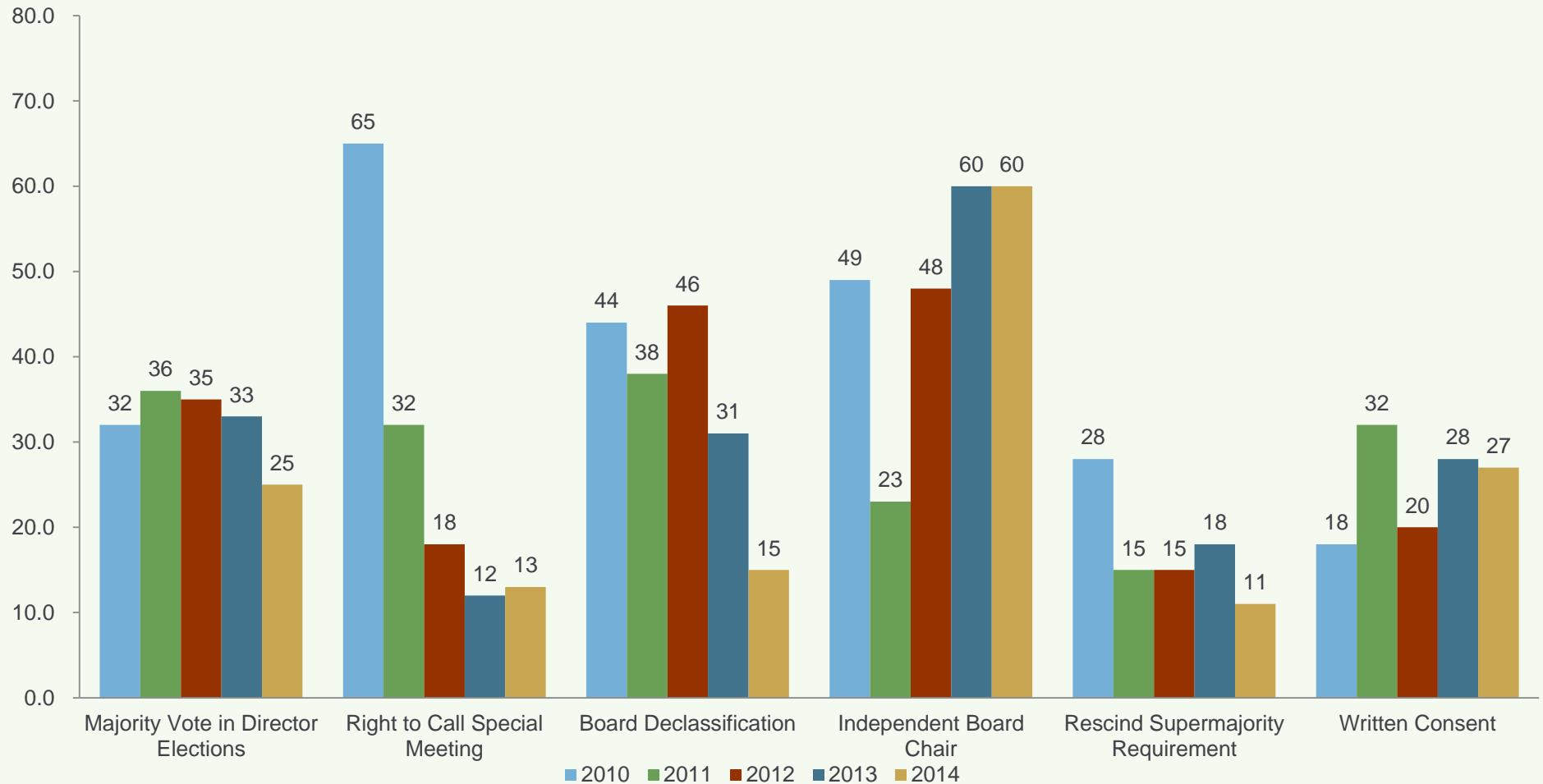
- SEC processed 285 no-action letter requests as of June, a 12% decrease year-over-year
- SEC staff no-action letter process included notable rejections of exclusion requests
 - Denied many companies' requests that proposals submitted by "proxy" should not be allowed unless there is clear evidence of authority
 - Focused on proposals submitted by John Chevedden on behalf of other retail shareholders
 - Denied many companies' requests that proposals be excluded for misleading supporting statements
 - Traditionally SEC staff expects companies to address the issue in the opposition statement
 - Companies have raised the issue to the staff of whether a demonstrably misleading statement could at least be removed
- Debate over the shareholder proposal process, including the SEC staff no-action letter review
 - Even the SEC Commissioners are critical, but from opposing perspectives
 - Commissioner Stein wonders if proposals asking banks to identify employees responsible for possible material losses should have been excluded by SEC staff
 - Commissioner Gallagher wants \$2,000 and one-year ownership requirement to be increased and claims proposals are not coming from "ordinary shareholders"
 - Nasdaq and CII in dueling WSJ op-ed pieces about the burden (or lack thereof) of shareholder proposals
 - Chambers petitions SEC on resubmission thresholds

1. Director Elections and Shareholder Proposals

- Lessons learned in 2014
 - Several governance proposals consistently receive majority support
 - Declassification, removal of supermajority provisions
 - Others have varying results depending on company practices that can sometimes affect proxy advisory firm recommendations
 - Special meeting (if company already provides the right at a higher threshold)
 - Independent chair (if company has a lead director that meets ISS criteria)
 - Majority voting (if company has a director resignation policy)
 - Many others traditionally do not pass, but some are getting closer
 - Proposals requesting political contributions (if the company currently reports little to nothing)

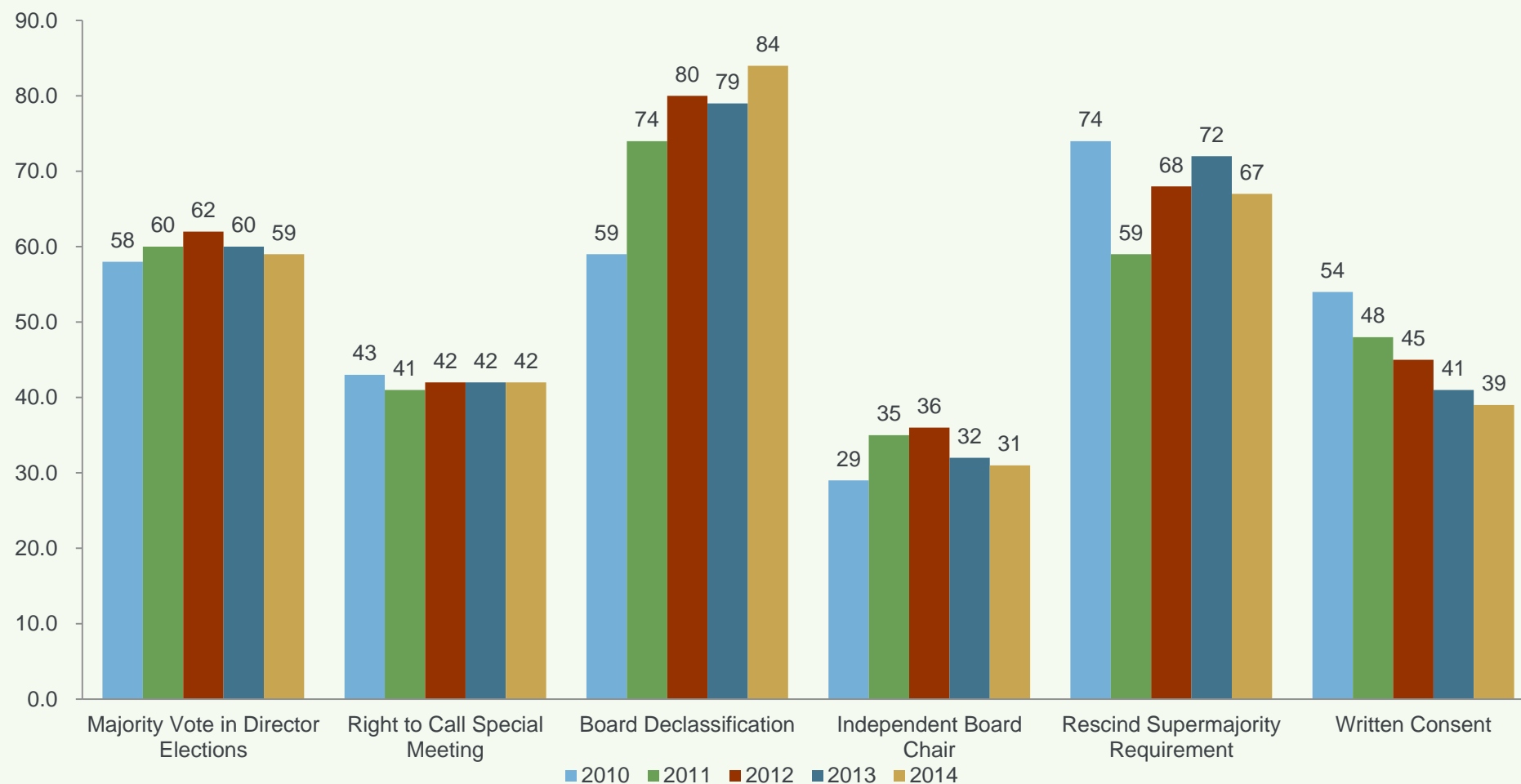
Shareholder Proposals on Governance in 2014

NUMBER OF SHAREHOLDER PROPOSALS VOTED ON (AS OF JUNE FOR 2014)



Shareholder Proposals on Governance in 2014

AVERAGE SUPPORT (%) (AS OF JUNE FOR 2014)



Notable Shareholder Proposal Results in 2014

GOVERNANCE PROPOSALS (AS OF JUNE)

■ Declassification

- Proposals continue to be submitted but is no longer one of the top ten most common proposals
 - Companies are aware that these proposals are likely to pass, so many agree to adopt rather than putting them to vote
- Involvement from Harvard Law School Shareholder Rights Project, which targets S&P 500 companies, has caused a tremendous decrease in the number of companies that have classified boards
 - Less than 10% of S&P 500 have classified boards, compared to 39% of mid-cap companies
- Average support for 15 shareholder proposals was 84%
 - Only 1 failed to pass
- Some management proposals to declassify requiring significant percentage of votes outstanding failed, likely as a result of NYSE policy change on broker voting
 - Makes it difficult for companies that already agreed to implement to actually put it in place

■ Majority voting

- Already adopted in some form by 86% of S&P 500 companies and 56% of mid-cap companies
- Level of shareholder support varies depending on whether companies have an existing director resignation policy
 - Although average support levels are at 59%, only 15 of 25 proposals passed
 - A handful of companies continue to resist even with majority support for the proposal and facing majority withhold for directors, including Vornado Realty which has ignored the proposal for many years

Notable Shareholder Proposal Results in 2014

GOVERNANCE PROPOSALS (AS OF JUNE)

- Independent chair
 - Larger companies less likely to have independent chairs
 - 20% of S&P 500 companies have independent chairs compared to 32% of Russell 3000 companies
 - Of the 60 shareholder proposals voted on, 4 passed
 - Allergan (50.5%); Healthcare Services Group (61%); Staples (50.7%); Vornado Realty (58.6%)
 - High support levels at several other companies: Altera (48%); Archer-Daniels (48%), Honeywell (49%); Wendy's (45%); Urban Outfitters (47%)
 - Many proposals are sent to companies that already have lead independent directors
 - Having a lead director does not deter proposals, but ISS will recommend against the proposal if a company has a lead director with sufficiently broad role, the company has no other governance issues and the company's TSR for 1- and 3- years outranks its peers
 - ISS is very strict about its requirements
 - ISS recommendation has a significant impact on voting results, as much as ~ 20% points difference
 - Governance matters that may cause a concern include perceived executive compensation issues
 - Some companies agreed to increased responsibilities for the lead director or other methods to negotiate for withdrawal
 - JPM agreed to study the issue; there are reports that it may hold a roundtable

Notable Shareholder Proposal Results in 2014

GOVERNANCE PROPOSALS (AS OF JUNE)

- Special meeting
 - Continued decline in numbers as a result of competing management proposals with different ownership thresholds
 - Proposals either seek a new right to call special meetings or lower the ownership threshold on an existing provision
 - Proposals asking boards for a new right generally receive higher support and several passed, while no proposal seeking a lower threshold passed
 - Indicates shareholders will accept provisions with >10% threshold sought by proponents (for example, Vanguard and T. Rowe fund 25% acceptable)
 - As a result of the shareholder proposals in the last few years, 60% of S&P 500 companies now provide shareholders with rights to call special meetings
 - Most Delaware companies provide the right at 25% ownership
- Written consent
 - Companies have traditionally argued that the right to call special meeting is the preferred shareholder empowerment mechanism
 - Some companies have adopted management proposals that provide for written consent provisions with appropriate safeguards and seek exclusion through the SEC process on the basis of conflicting proposals, similar to special meeting situation
- Significance: under Delaware law shareholders can remove a declassified board without cause, so the combination of declassification plus shareholder ability to act unilaterally means that the board will be subject to removal on short notice at all times.

Notable Shareholder Proposal Results in 2014

PROXY ACCESS DEVELOPMENTS IN 2014 (AS OF JUNE)

- Proxy access is the ability for shareholders to submit director candidates for inclusion on company proxy cards
 - SEC rule that would have applied to all public companies was struck down by DC Circuit, and former SEC Commissioner Mary Schapiro indicated the SEC had no capacity to re-examine rule
- 2012 was the first year of “private ordering” for proxy access through the Rule 14a-8 process
 - About 8 companies have adopted since then (including H-P, Western Union, Chesapeake)
 - In 2014, 10 proposals of two different types were submitted
- Proposals seeking 3% thresholds had higher votes and likely to win
 - 3% ownership for 3 years required to nominate directors, limited to 20% of board
 - In 2012 passed at Nabors Industries (56%) and Chesapeake Energy (60%)
 - In 2013 passed at CenturyLink (71.5%), Nabors and Verizon
 - In 2014 passed at 4 companies (Boston Properties, International Game Technologies, Big Lots, Nabors)
- 1% ownership for 1 year had much lower votes, traditionally because the proxy advisory firms did not support them
 - Some retail investors are now increasing the ownership thresholds in order to receive ISS support for the proposal
 - Asks for either 3% for 3 years ownership or 25 shareholders who have held for 3 years
 - These may fare better, not yet tested

Notable Shareholder Proposal Results in 2014

SOCIAL PROPOSALS (AS OF JUNE)

- Most prevalent issues include political contributions and lobbying spending (continues to dominate top ten most common proposals)
 - 81 proposals, average support at 24%
 - 3 passed – Dean Foods; Lorillard; Valero Energy
 - Proponents include AFSCME, Walden, Center for Political Accountability
 - Some proposals call for clear reporting of contributions and expenses while others seek reporting of matters such as alignment of contributions with corporate values
- Environmental/climate change issues
 - 10% increase this year with 55 proposals on climate change alone (17 in 2013)
 - Some ask companies to adopt GHG reduction goals and others ask companies to address climate change risks (include carbon asset risk / carbon bubble)

2. Annual Meetings in 2014

- Directors are held responsible for major business and regulatory events at companies
 - Wal-Mart: FCPA issues
 - Target: Cybersecurity breach
 - Duke Energy: Coal ash spill
- “Vote no” campaigns focus on compensation issues
 - Wintergreen Advisers targeted Coca-Cola's equity plan (high dilution, inadequate disclosure) which received 83% in favor (Buffet abstained, owned 9%)
 - YRC Worldwide (Teamsters) - equity plan, say-on-pay, compensation committee
 - CtW targeted several fast-food companies' say-on-pay votes as referendums on “human capital” (wage issues)
 - Credited in part for Chipotle's failed vote; 75% opposition was the most negative say-on-pay vote in 2014
- Annual meetings are used as a protest opportunity
 - Duke Energy, BofA, Wells Fargo, Wal-Mart (wage issues)
- Meeting locations and lack of webcasts spotlighted
 - Some companies are hosting annual meetings at different locations each year
 - Criticized for not providing webcasts

3. Activists Going to the Shareholders

- Overview of proxy fights
 - More than 40 activist actions in 2014 season as of early June, (9 won by management, 6 by dissidents and 10 settled)
 - Others never turned into contests or are ongoing
 - Most sought board representation, not control or attempts to acquire the company
 - In the past ten years, there have been 56 proxy fights for board control or minority representation
 - A “short slate” strategy can be more difficult to defend, more likely to receive ISS support and significantly distract management
 - 60% of proxy fights that went to a vote in 2013 resulted in partial or total success for the activist compared to 39% in 2003
 - Speculation that uptick in activist success rate is attributable in large part to widespread support from mainstream institutional investors
- Even without actual proxy fights, the number of large-cap companies targeted by shareholder activists has more than doubled since 2010
 - 42 large-cap companies were targeted in 2014 vs. 17 in 2010
- Activist demands for alternative business strategies include:
 - dividends or stock buybacks (Apple)
 - spin-offs of business divisions (DuPont, Dr Pepper Snapple, PepsiCo and Kraft)
 - acquisitions (PepsiCo / Mondelez)
 - dispositions (Cracker Barrel)

3. Activist Contests

- 21 major contests on the ballot between April to June. Some examples:
 - Cracker Barrel – shareholders rejected Biglari Holding’s proposal to sell the company
 - Sensient Technologies – 4 dissidents proposed by FrontFour Capital not elected
 - Darden – Starboard received support to call a special meeting, but company announced it would sell Red Lobster anyway
 - Commonwealth REIT – held a special meeting to elect new directors nominated by Corvex and Related after their successful consent solicitation
 - Sotheby’s – negotiated with Third Point after highly publicized case, will add 3 dissident nominees to board
- Some activists are using non-binding proposals (primarily Rule 14a-8) to increase the pressure
 - Ichan at Apple – asked Apple to commit to not less than \$50 billion of share repurchases during 2014 fiscal year
 - Also filed tweets in support as non-exempt solicitations on Apple’s Edgar site
 - Ichan at eBay – vote on whether company should spinoff PayPal
 - Starboard at Red Lobster – proposal not to approve any Red Lobster plan without shareholder vote
 - Pershing Square filed an initial proxy statement for Allergen soliciting shareholders to vote on a non-binding resolution to request that shareholders ask the board to engage in good faith discussions with Valeant on its merger offer
 - The resolution is now part of Pershing Square’s proxy statement seeking a special meeting to vote on new dissident directors

4. Company By-laws

EXCLUSIVE FORUM

- Exclusive forum bylaws
 - Mandating that certain shareholder litigation be channeled to an exclusive jurisdiction, usually Delaware (but also other states)
 - Designed to curtail forum shopping and parallel multi-forum litigation
 - In June 2013, the Delaware Court of Chancery issued the *Chevron* opinion holding that exclusive forum jurisdiction bylaws are facially valid, as both a statutory and contractual matter (October 2013 appeal dropped)
 - These bylaws remain subject to equitable challenges based on facts and circumstances
- Shareholder and proxy advisory firm reactions in 2014
 - No known shareholder proposals asking for the provision to be repealed
 - If a board adopts the bylaw unilaterally
 - ISS has not taken action, but Glass Lewis policy is to recommend against the nominating committee chair
 - ISS 2015 policy survey will re-examine its current position on exclusive forum and other board-adopted bylaws
 - Glass Lewis position has some impact on the vote results for the nominating chair, but not cause majority negative support
 - If a company seeks shareholder approval, both firms will generally recommend against the ballot item
 - Despite the negative recommendations, between January 2013 and May 2014, 8 of 14 companies managed to have the proposal pass and 6 are pending

4. Company By-laws

EXCLUSIVE FORUM

- Recent cases have increased interest and momentum
 - State courts that have considered enforceability (including California, NY, Illinois and Louisiana) have upheld the provisions based on the facts and circumstances of those cases
 - Over 250 public companies (including 32 S&P 500 companies) have adopted exclusive jurisdiction bylaws
 - Becoming common for IPO or spin-off companies as companies go public, although usually in charters
- CII and AFL-CIO strongly urge companies not to adopt these bylaws
- Considerations for companies thinking of adopting an exclusive forum bylaw
 - Company-specific history of shareholder or derivative litigation
 - Relationship with shareholders and their policy guidance on exclusive forum provisions
 - Whether company has other controversial issues at the next meeting so that this may be an additional distraction
 - Any potential advantages in home state vs. state of incorporation
 - Whether forum chosen is trending pro-company or questionable

4. Company By-laws

DIRECTOR COMPENSATION

- Director qualification and compensation bylaws
 - In 2013, at least 30 companies adopted bylaws prohibiting third-party director compensation
 - In response, in 2014 ISS developed a policy that it will recommend against directors who serve on the corporate governance committee of a company that adopted such bylaws
 - ISS recommended against the nominating and governance committee at Provident Financial in late 2013, and the directors received approximately 66% in support
 - Provident Financial repealed and will seek shareholder approval at its November 2014 meeting coming up
 - CII has urged the SEC to require disclosure of third-party director compensation
- During 2014 proxy season, 27 of 33 companies amended their bylaws and removed the provision
 - At least one or more significant shareholders likely played a role in questioning the provision and pressured some of the companies for removal of the bylaws
 - 2 companies asked shareholders to approve the bylaws (ISS recommended against the ballot item)
 - Wynn Resorts (May 2014) – 60% voted against the bylaws and the company repealed the provision
 - First Reliance (June 2014) – 86% voted to support the bylaw
 - Insiders own 15%, company ESOP owns 6% and one shareholder (Service Capital) owns almost 8%
 - While 26 of the 27 companies changed their bylaws before their annual meeting, National Fuel Gas waited until June and indicated that they will ask their shareholders to approve the bylaw at its 2015 meeting
 - At its March meeting, all of the directors up for election were new nominees so ISS did not hold them responsible and did not recommend against them
 - One director during the 2014 season received less than majority support as a result

4. Company By-laws

FEE SHIFTING

- On May 8, 2014 Delaware Supreme Court issued the *ATP* decision, in response to a certified question of law from federal court, that a board-adopted bylaw that provided for a losing plaintiff to pay defendants' attorneys' fees and costs associated with intra-corporate lawsuits is facially valid
 - Company at issue in the case is a non-stock corporation
 - Warned that the fee-shifting bylaw would not be valid if used for inequitable purposes
- In response, Corporate Law Section of the Delaware State Bar Association has proposed that DGCL be amended to limit the effect of the ruling for stock corporations over concerns that it will restrict claims from being brought
 - But opposition from the Chamber of Commerce has delayed the debate on the proposed Delaware legislation
 - Recently, the Delaware State Senate passed a resolution calling for continued evaluation of the proposed amendments
 - No action is expected until at least January
- As of mid-July, 6 public (or IPO companies) have adopted
 - Most are small and may not be covered by the proxy advisory firms
 - Two adopted in response to litigation, and two of the provisions are part of current litigation so may have some judicial resolution before Delaware legislature acts

5. Regulatory Rulemaking Wheels Grind Slowly

SEC PAY RATIO RULE

- Pay ratio rule proposed as required by Section 953(b) of the Dodd-Frank Act mandates the disclosure of
 - Median of the annual total compensation of all employees, except the CEO
 - Annual total compensation of the CEO
 - Ratio of these two amounts
 - EXAMPLE: The median employee's compensation is \$40,000, and the CEO's compensation is \$8 million. The ratio is 1 to 200 (or, the CEO's compensation is 200 times the median of all employee's compensation).
- Highlights of Proposal
 - Covers all U.S. public companies, except emerging growth companies, foreign private issuers and smaller reporting companies
 - Covers all employees (including part-time, temporary, seasonal and non-U.S.) as of FYE
 - Cannot gross up seasonal or part-time employee compensation to reflect FTE salary
 - Flexibility in determining the "median employee" – e.g., companies may use statistical sampling, consistently applied compensation measures, etc.; reasonable estimates permitted
 - Total compensation calculated pursuant to the Summary Compensation Table under Item 402(c) of Reg S-K
 - Reasonable estimates are permitted (e.g., multiemployer plan benefits, non-U.S. benefits)
 - May voluntarily include certain otherwise excluded compensation, as long as included consistently and for both the median employee and the CEO (e.g., health care benefits, perks < \$10,000, etc.)
 - Must provide brief disclosure of methodology
 - For calendar year companies, will first apply to proxy statements filed in 2016 (covering 2015 compensation), assuming finalization of rule in 2014
 - SEC's proposal was approved in a 3-to-2 partisan vote

5. Regulatory Rulemaking

REMAINING CORPORATE GOVERNANCE PROVISIONS THAT MUST BE PROPOSED

Pay and Performance Disclosure

The SEC must issue rules requiring disclosure in annual meeting proxy statements of Item 402 compensation, including the relationship between executive compensation actually paid and the companies' financial performance, taking into account changes in the value of stock and dividends and distributions.

Employee and Directors Hedging Disclosure

The SEC must issue rules requiring disclosure in annual meeting proxy statements of whether employees or directors are allowed to hedge the value of equity securities.

Clawback Policies

The SEC must issue rules requiring companies to develop and implement policies with respect to (1) disclosure of incentive-based compensation that is based on publicly reported financial information and (2) clawback of incentive-based compensation from current or former executive officers following a restatement triggered by material noncompliance with any financial reporting requirements under securities laws.

Amount subject to clawback is tied to compensation during the 3-year period preceding the date on which the company is required to prepare the restatement, based on erroneous data, in excess of what would have been paid under the restated results.

SEC expects to propose each over next year – “medium burner”

5. Regulatory Rulemaking

SEC TALKS ABOUT POSSIBLE AREAS OF CHANGE

- Possible governance areas of focus beyond Dodd-Frank requirements, but even these issues show a divisive SEC at the top
- Disclosure reform
 - Chair White and Corp Fin director Keith Higgins have spotlighted the need to update the SEC disclosure rules
 - SEC issued report as mandated by Dodd-Frank with possible areas for reform: consolidating risk-based disclosure such as risk factors, legal proceedings and market risk disclosure; updating the relevancy of disclosures regarding businesses and properties; avoiding boilerplate for corporate governance requirements; addressing concerns that executive compensation disclosure is too long and technical; and making offering-related disclosure reflect the existing market
 - Commissioner Gallagher strongly supports cutting back, including the possibility of putting basic corporate information in an online disclosure system
 - Also laments that Congress and third-parties are using securities disclosure to push policy objectives (political contributions, conflict minerals and resource extraction disclosure as examples)
 - But Commissioner Stein warns that “better disclosure is not at all synonymous with less disclosure”
 - As an example, investors may not have enough information about issuers’ reliance on short-term funding for their long-term obligations

5. Regulatory Rulemaking

SEC TALKS ABOUT POSSIBLE AREAS OF CHANGE

■ Proxy advisory firms

- Even members of Congress have asked the SEC to weigh in on influence of proxy advisory firms and potential conflicts of interest
- Commissioner Gallagher has blamed the SEC for the “significant role” in the rising influence of proxy advisory firms
 - Rules adopted in 2003 under the Investment Advisers Act required advisers to adopt and implement policies and procedures designed to ensure that their clients’ proxies are properly voted, and that adviser can demonstrate the absence of a conflict if the adviser votes proxies in accordance with a policy based on the recommendations of an independent third party
 - Led the SEC to issue no-action letters to proxy advisory firms Egan-Jones and ISS that their recommendations are in fact independent of an investment adviser and cleanses that adviser’s conflict
- On June 30, SEC Staff release a legal bulletin outlining certain responsibilities of investment advisors and proxy advisory firms (see page 41 for details)

■ Whistleblowers

- Chief of whistleblower office warned companies about confidentiality, separation or employee agreements that require employees to agree that they will not report issues to a regulator in order to obtain the benefits under the contracts
 - Indicated that they will “go after” the lawyers who prepared the agreements

5. Regulatory Rulemaking

PCAOB

■ Adopted

- Auditing standard No. 18, which covers additional procedures for related party transactions, significant unusual transactions and financial relationships and transactions with executive officers
 - Auditors will need to discuss related party transactions with audit committees

■ Proposed

- Auditors must affirmatively comment, in their audit report, on the absence of a material inconsistency or a misstatement of fact in the “other information” section in annual reports
 - Would cover the full document - management's discussion & analysis, compensation, business, risk factors, etc.
 - The auditor would need to make a similar determination in connection with quarterly reports
 - Auditors are likely to have to significantly expand their audit procedures as a result of this requirement, leading to higher costs and lead times for annual and quarterly filings
- Auditor must also communicate in their audit reports the “critical audit matters”
 - Auditors would be required to disclose:
 - the “critical audit matters”
 - the considerations that resulted in the determination that a “critical audit matter” existed
 - refer to the relevant financial statement accounts and disclosures that relate to the “critical audit matters,” when applicable.
 - This proposal would also likely add to the time and cost of audits, and significantly lengthen audit reports
- Pending final approval by the PCAOB and the SEC, these proposals would take effect for fiscal years beginning on or after December 15, 2015.

5. Regulatory Rulemaking

PCAOB

- Discarded (for now)
 - Mandatory auditor rotation
 - EU adopted mandatory rotation for every 10 years but with possible extensions, with a transition period of about six years
- Considering
 - Reproposed disclosure in the auditor's report of the name of the engagement partner and the names, locations, and extent of participation of other independent public accounting firms that took part in the audit and the locations and extent of participation of other persons not employed by the auditor that took part in the audit
 - Concerns raised over increased litigation risk

5. Requests for SEC Intervention

SEC FACES PETITIONS AND REQUESTS FOR CHANGES

- All sides want SEC intervention, including Congress
- Proxy advisory firms
 - 10 members of Congress sent letter to Chair White expressing concerns about firms' conflicts and overreliance on proxy advisors by investors
- Faster reporting (13D/13F)
 - Petition for shorter reporting deadlines for 13Ds and 13Fs
- Interim vote tallies
 - Broadridge will provide if issuer agrees and proponent signs confidentiality agreement
 - CII seeks SEC guidance, including requiring that companies disclose the tallies in Form 8-Ks
- Political contributions
 - Group of law professors in 2011 asked SEC to require political contributions disclosure and SEC faced outcry in late 2013 after it removed issue from rulemaking agenda
- Universal proxy ballots
 - CII petitioned the SEC for the ability to “mix and match” director candidates on a universal proxy card in contested elections, an option that is only available for those who attend the meeting in person
- Shareholder proposals
 - Chamber, NACD and others want increased resubmission thresholds
- Climate change disclosure
 - Ceres (sustainability nonprofit) asked SEC to prioritize climate change disclosure by issuing more comment letters to strengthen the reporting under the SEC's 2010 guidance calling for the disclosure

5. Requests for SEC Intervention

ACTIONS SEEM UNLIKELY

- Commission continues to struggle with completing Dodd-Frank rulemaking
- Commissioners also publicly divided on many issues
 - Commissioners Stein and Gallagher published opposing statements regarding WKSI waiver granted to Royal Bank of Scotland
 - Commissioner Gallagher has long been critical of SEC's no-action letters that he believes supports proxy advisory firm influence
 - Commissioners Gallagher and Piwowar wanted full stay of SEC conflict minerals rule after court struck down a portion of the rule

6. Board Composition/Director Refreshment

FOCUS ON TENURE

- Increasing focus on director tenure, with no consensus emerging
 - Some question whether long tenure affects director independence
 - Others believe seasoned directors make better directors
 - More thoughtful view: focus less on individual tenure and more on mix of board. Is the board getting fresh perspectives from new members?
- Average director tenure at S&P 1500 is 10.8 years (up from 8.7 years in 2008)
 - Only a year difference between large-cap and mid-cap
 - 53% – 9 to 15 years average tenure; 28% – over 12 years tenure
- Investors are starting to examine tenure
 - State Street policy provides specific guidance relating to the number of years of tenure and will screen a company based on whether its average board tenure is above market
 - State Street determined average tenure at their portfolio companies is 9 years
 - Companies with entire boards' average tenure > 12 years may receive a letter
 - Companies with 1/3 of non-executive directors of average tenure > 17 years may receive negative or withhold votes if those directors sit on key independent committees, unless the company has director succession plan in place
 - Other investors do not have a strict policy at the moment, but may be focused on the general mix and turnover

6. Board Composition/Director Refreshment

FOCUS ON TENURE

- ISS consultation period raised tenure as a potential new policy issue for recommending against directors
 - ISS QuickScore judges directors with more than 9 years tenure to be “excessive” and will weigh this as a negative factor depending on the proportion of directors with such tenure
 - ISS 2015 policy survey does not include tenure as a question, so it appears unlikely that questions of tenure will cause negative recommendations for the 2015 proxy season
- Term limits are not common but some companies have adopted them
 - Disney – 15 years; Target – 20 years

7. Board and Committee Responsibilities

OVERSIGHT ISSUES INCREASE

- Risk oversight by boards continue to be emphasized with new topics added
- Cyber-security risks
 - Surveys find a significant increase in boards' awareness of the nature, extent and consequence of cybersecurity breaches
 - Questions have been raised about whether boards need members with specialized expertise on the issues
 - Commissioner Aguilar urges boards to ensure appropriate oversight, including understanding budgets for privacy and IT security programs, assigning roles and responsibilities and receiving regular reports on breaches and IT risks
 - ISS held Target directors responsible (by recommending against them) for company's security breaches
- Sustainability issues
 - More than half of S&P 500 companies' boards have explicit oversight responsibilities for social and/or environmental issues
 - Most common for paper and forestry, healthcare, oil and gas, utilities and aerospace and defense
 - 1/3 assigned it to Nominating Committee and about 1/3 have a Public Affairs or Sustainability Committee
 - 72% of S&P 500 companies published a sustainability corporate responsibility report in 2013, up 52% in 2012
 - Different and at times conflicting groups (GRI, SASB, CERES) demanding disclosure against certain benchmarks makes reporting complicated
 - Some want the disclosure in '34 Act filings instead of in separate reports

7. Board and Committee Responsibilities

OVERSIGHT ISSUES INCREASE

- Audit committees
 - Court finds claims could proceed against audit committee at Longwei for missing red flags
 - SEC brought two enforcement cases against audit committee chairs in 2014
 - AgFeed Industries based in China but audit committee chair was based in US – SEC alleges that he ignored evidence of accounting fraud
 - L&L Energy Inc. based in China and Taiwan for signing an annual report that the audit committee chair knew or should have known contained a false SOX certification (naming a CFO who had declined to take the position)
 - Increased demands on audit committee reports to provide more information
 - Governance groups (NACD, Tapestry and others) urge companies to include factors considered for appointing the audit firm, involvement in selecting engagement partner after rotation, setting auditor compensation and describing how the committee evaluates the auditor
 - Chair White has indicated that the SEC staff is considering whether improvements can be made to the reports
 - ISS 2015 survey policy includes questions on whether the presence or absence of additional disclosure should impact recommendations for audit committee members
 - SEC 21(a) report on auditor independence indicates that audit committees should evaluate prohibition on accountants “acting like employees” after enforcement cases settled

8. Shareholder Engagement

REACHING OUT TO INVESTORS

- Increasingly expected by investors
 - Level of engagement has spiked
 - Key input from investors: “engagement” is different from “solicitation”
- Process varies greatly from company to company
 - Largely a matter of company preference, sometimes in consultation with the board
 - Many large-caps have made this more routine
- Governance outreach differs in many ways from traditional IR outreach
 - Centered around governance, proxy disclosure, compensation and other board and annual meeting issues
 - Business operations may influence discussions only insofar as investors are concerned that they represent lack of governance oversight (such poor results because board is not involved in strategy or pay for performance questioned)
 - How proxies are voted
 - At many of the largest institutional investors, there is a separate governance group that votes on the proxy (BlackRock, Fidelity, Vanguard)
 - Sometimes portfolio managers weigh in, other times there are “walls” between the investing side and the proxy voting side
 - Some investors have proxy voting committees that meet and decide on how to vote on difficult or contentious issues
 - Purpose of governance engagement is also different than traditional IR outreach
 - Large part of engagement is to know and “meet” the governance voting decision-maker at the investors
 - Useful to know in advance if investor has a particular issue with the company, because that can be difficult to discern from aggregated vote result
 - Also, if an issue arises during proxy season, investors can be reached quickly if there is already a relationship, and easier to convince them of the company’s position
 - Some investors will expect companies to reach out if they voted against the company

8. Shareholder Engagement

REACHING OUT TO INVESTORS

- Major institutions will expect companies to be aware of their individual voting guidelines prior to engagement (can be found on their websites)
 - Some investors have specific, and stricter, policies on certain matters than do ISS or Glass Lewis
 - Investors prefer that the initial engagement takes place during the off-season since they are bombarded with requests during annual meeting season
 - Some investors are pleased to have companies just “check in”
- Directors are usually not involved if the engagement is “routine” or “check in” or “meet and greet”
 - Directors take part in engagement only if there are crisis issues or CEO compensation issues (some investors will not talk to management about CEO compensation)
 - Investor requests to speak to directors continue to be rare

8. Shareholder Engagement

INVESTORS BECOME PROACTIVE AND ADVISORY GROUPS FORMED ON ENGAGEMENT

- Vanguard sent letters to S&P 500 companies seeking adoption of annual elections, majority voting and special meeting rights at 25% ownership thresholds
- Different groups formed that developed “standards”
 - Shareholder-Director Exchange Protocol (SDX Protocol) includes Vanguard, Calvert, BlackRock, Hermes, NACD, CalPERS and several directors
 - Boards are encouraged to meet with shareholders to discuss governance, management performance and deal activity, not business operations or results which is for management
 - When either a company or investor wants to engage, they will approach designated contacts and request a meeting which the other side will agree to within 20 business days
 - Calls for independent nonexecutive chair or other lead director to attend, discourages attendance by management and lawyers
 - While there is no evidence that SDX Protocol is gaining traction among companies, in July the group sent letters to lead directors and corporate secretaries of every Russell 1000 company, asking public company boards to “consider adopting and clearly articulating a policy for shareholder-director engagement, whether through adoption of the SDX Protocol or otherwise.”
 - Conference Board Task Force on Corporate/Investor Engagement includes Relational Investors, T. Rowe, Warburg Pincus and many directors
 - Recommends companies should listen to one another, and directors should especially listen to investors
 - Investors should conduct their own research before voting
 - Distinguishes itself from SDX by stating that it should not be routine for directors and shareholders to talk, also worries about “overengagement”

8. Shareholder Engagement

NEGOTIATING ON PROPOSALS

- Negotiations lead to vast numbers of shareholder proposals being withdrawn
 - eBay – proposal to divest PayPal (Carl Icahn)
 - Agreed to appoint a single independent director recommended by Mr. Icahn
 - Apple – board diversity
 - Agreed to stronger language in its nominating committee charter with respect to board diversity
 - Disney and JPM – independent chair
 - Disney agreed to amend its corporate governance guidelines to include a (carefully hedged) statement that in the future the chairman would “in the normal course” be independent unless the board determined otherwise
 - Exxon – climate change
 - Agreed to publicly disclose its carbon emissions
 - Verizon – agreed to provide shareholders with interim vote tallies

9. Executive Compensation

PRELIMINARY SAY-ON-PAY 2014 RESULTS

- Current voting results for Russell 3000 companies
 - 75% received over 90% approval (77% in 2013)
 - 16% received between 70% – 90% approval (14% in 2013)
 - 6% received between 50% – 70% approval (6% in 2013)
 - 48 Russell 3000 companies (2.3%) have failed so far compared to 57 (2.5%) in all of 2013
- Cumulative results
 - 92% of all companies have passed all 4 years
 - 7% have passed in three years and failed in one year
- Companies with triennial say-on-pay sought votes in 2014
 - Similar results as annual say-on-pay companies (91% average for 316 companies)
- ISS Influence
 - ISS has recommended that shareholders vote ‘against’ at about 13% of companies it has assessed (14% in 2013 and 14% in 2012)
 - On average, shareholder support was 28% lower at companies with an ISS ‘against’ (29% in 2013)
 - ISS has switched its recommendation at 16% of companies after changes were made

9. Executive Compensation

FAILED VOTES IN 2014 AS OF JUNE 2014

- 48 failed votes for Russell 3000, but only 5 in the S&P 500
 - Staples, Hasbro, Expeditors International, Nabors, Chipotle
- Reasons for better results at S&P 500 companies
 - More sensitive to and adept at responding to emerging governance practices and say-on-pay nuances
 - More resources generally to devote to issues and shareholder engagement
 - Better able to get shareholder attention for engagement
 - Companies have recognized hot button issues and in many cases have changed their practices
- Reasons for the failed votes, according to ISS (all companies had more than one reason cited)
 - 88%: perceived pay for performance disconnect, either in relation to stock performance and/or ISS peer group comparison
 - 85%: problematic pay practices
 - 69%: rigor of performance goals
 - 52%: special awards or mega grants
 - 38%: insufficient shareholder outreach and disclosure
 - 33%: non-performance based equity (includes options)
 - 19%: benchmarking practices

9. Executive Compensation

STRATEGIES FOR SAY-ON-PAY

- Recognize that one year's vote results may have no impact on next
 - A strong showing of positive support in one year may have little effect on the results for the following year
- Understand proxy advisory firm policies
 - Compensation committees should make decisions in the best interest of the company and its shareholders, but staying knowledgeable about the policies will help avoid surprises
 - Review reports for “warnings” about practices even if overall recommendation is positive
 - Recognize potential impact of negative recommendation and develop action plan if possible
- Understand voting policies of top shareholders
 - Many major shareholders follow their own guidelines
 - Proxy solicitors can help identify top holders, their policies and how they use advisory firm reports
- Engage with proxy advisory firms in off-season
 - Generally will not talk to companies during proxy season
- Engage with shareholders
 - Begin reaching out to top shareholders in the “off-season” even if company did not have any issues
 - Know whom to talk to – portfolio manager and/or governance professional
 - Off-season engagement is ideal
 - Focus during off-season should be on governance overall, not just compensation
 - Regular course meetings will make it easier to reach out to those shareholders when needed during the pressures of proxy season

9. Executive Compensation

SHAREHOLDER PROPOSALS (AS OF JUNE)

- For the first time, 5 proposals to limit accelerated vesting upon a change of control wins majority support (average support was 37% for 25 proposals)
 - Including Valero Energy, which has announced that it will implement the proposal
 - Proposal calls for policy that there is no accelerated vesting of performance shares upon change in control, other than vesting on a partial (pro rata) basis at the time of termination
 - Proposal is more than double-trigger vesting after change of control
 - Some companies manage to exclude under “conflicting proposal” (14a-8 (i)(9)) argument if they were putting up an equity plan for vote that has a different change-in-control provision (which is likely in almost all equity plans)
 - Results could give momentum to seeing a lot more of these proposals in 2015
- Other compensation-related proposals include stock retention (hold past retirement) proposals, which averaged 23% approval

10. Proxy Advisory Firm Influence

- Awareness of proxy advisory firm policies have become part of proxy season planning
- The advisory firms influence all aspects of ballot items, including director elections and equity plans
 - For director elections, some of the advisory firms' policies match those of major institutional investors, especially on issues like meeting attendance
 - Some companies are surprised by the advisory firms' own assessment of director independence, which may lead the firms to recommend against directors who sit on the independent committees
 - On equity plans, some companies pulled their plans off the ballots this year after discovering the advisory firms would recommend against them
 - The calculations remain complicated and many companies hire advisors (ISS corporate services, compensation consultants or proxy solicitors), who can try to duplicate and estimate what is necessary to receive favorable recommendations
- On June 30, SEC staff issued guidance in the form of Staff Legal Bulletin 20 outlining responsibilities of investment advisers that use proxy advisory firms and the firms themselves
 - Investment advisers are required to vote in accordance with clients' wishes, including not voting at all, only voting on some matters, or voting in favor of management or certain proponents.
 - To appropriately carry out their voting responsibilities, investment advisers must establish policies and procedures, which includes the ability to retain third parties that provide voting recommendations on how proxies should be voted.
 - Investment advisers that retain proxy advisory firms for this purpose must undertake due diligence to ensure that those firms have adequate resources and are providing voting recommendations based on accurate information, including investigating material errors made by proxy advisory firms that
 - Proxy advisory firms must describe conflicts of interests in some detail to rely on exemptions from proxy rules, but only to their clients and not publicly

10. Proxy Advisory Firm Influence

- On shareholder proposals, companies try to achieve favorable recommendations even without implementing the proposal directly if possible
 - Having a lead director with specific responsibilities to overcome an independent chair proposal as one example
- Reduced reliance on ISS can lead to a variety of policies at different institutions, some of which may be more demanding than ISS.
 - JPM has stricter overboarding policies; State Street has stricter director tenure policies
- ISS released its policy survey for 2015 season in July, and the questions inform changes for the next season
 - Governance policy questions include:
 - *Unilateral bylaw amendments or adoption.* Whether (a) boards should be free to adopt any bylaw or charter amendments, (b) boards should be free to adopt any bylaw amendments if shareholders have unfettered (no supermajority) rights to repeal the provision or (c) boards should never adopt amendments that negatively impact shareholder rights without their approval.
 - The survey also includes a list of factors that may be considered when boards adopt bylaw amendments, including the level of board independence, the directors' "track record" of other unilateral actions, the provision being adopted and the vote standards for shareholders to adopt bylaw amendments.
 - The survey discusses the types of bylaw amendments that may be a concern for shareholders, including adopting exclusive forum, fee-shifting or director compensation provisions, increasing authorized capital, increasing advance notice requirements, lowering quorum, and diminishing shareholder rights to call special meetings or act by written consent and classifying a board.
 - Finally, the survey questions whether directors should be held accountable if "shareholder-unfriendly" provisions were adopted prior to the company's IPO. It is unclear what constitutes sufficiently "unfriendly" provisions for this question, but it may include board classification.
 - *Gender diversity.* Whether. gender diversity is considered at all, and if so (a) only in relation to overall board gender diversity, (b) overall board diversity or (c) for new nominees only.

10. Proxy Advisory Firm Influence

- *Risk oversight and audit.* The survey asks about the significance of numerous factors when evaluating the board's role in risk oversight in investors' voting decisions on directors, including the board's risk oversight policies and procedures, boardroom oversight actions before and after "the incident" and changes in senior management.
- *Auditor ratification and election of audit committee members.* The survey asks about the significance of numerous additional disclosures about the audit committee's role and involvement regarding the auditor, prior to investors voting on both auditor ratification and election of audit committee members, including disclosure of audit committee oversight, involvement in the selection of the lead engagement partner, factors considered in appointing the auditor, degree of interaction with the auditor, considerations of audit firm tenure and rotations, and considerations regarding auditor compensation.
- Compensation-related questions
 - *Pay for performance.* Whether (a) the compensation committee should have broad discretion to set performance goals and target awards, (b) goals should be set independently of target awards or (c) target awards should be modified if goals are reduced.
 - *Magnitude of CEO pay.* Whether (a) absolute limits on CEO pay should be evaluated, regardless of performance, (b) proportional limits should be set in relation to absolute company performance or relative to peers or (c) magnitude is not considered.
 - *Responses to say-on-pay votes.* Whether positive changes to the pay program that will be implemented in future years can mitigate existing pay-for-performance problems.
 - *Equity plans.* ISS plans to implement a "balanced scorecard" approach to evaluating plan proposals and asks in the survey what weight should be given to plan costs (economic or voting power dilution), features (vesting, acceleration, liberal share recycling) and company practices (historical burn rates or use of performance-based grants).

Trends for 2015

- Early expectations are of a fairly quiet proxy season, similar to 2014
- SEC rulemaking coming
 - Expect the SEC to adopt pay ratio by end of 2014 (with possible implementation for 2016 proxy) and propose at least some of the other three backlogged rules
- Shareholder activists
 - Hedge fund activists will continue to influence the market and target companies in public ways
 - Retail and other activists continue to carry the torch for their favorite issues through Rule 14a-8 proposals
 - ESG issues starting to gain more traction
 - Likely increase in withhold recommendations
 - Tangible consequences for choosing not to adopt changes recommended in prior year by shareholders
- Public focus on governance
 - Companies will need to continue to manage adverse publicity arising from attention on governance matters, especially larger companies
 - Business issues likely to spill over into governance as investors hold boards accountable for business missteps
- Say-on-Pay will be a key focus, again
 - Investors expect companies to understand their concerns and issues surrounding pay given several years of experience
 - Companies with lower votes in prior year will continue to need to make meaningful changes
 - ISS policy survey suggests closer scrutiny for target and pay alignment and CEO pay magnitude

Trends for 2015

- Shareholder engagement and proxy advisory firms

- Investors are becoming more sophisticated in their focus on governance issues and companies are responding with regular communications
- Proxy firms' influence on votes is a reality for companies to deal with, as it is unlikely to change
- ISS 2015 policy survey questions suggest possible increased focus on much of the hot trends discussed in this presentation, including board risk oversight, bylaw amendment adoptions, board composition and disclosure about auditors

- Shareholder proposals

- Governance proposals will continue to receive high support – as more companies adopt governance practices, more investors come to expect those practices from all companies
 - If company performance improves, some investors may give specific companies more leeway on certain issues
 - Shareholder profile becomes more important when votes are close
- Certain executive compensation proposals becoming more prevalent
- Political contributions and lobbying proposals the most common form of social policy proposals and pressure will increase on companies to adopt, even without high votes for the proposals